Faith, Money, and Duty: The Purity of Exclusionary Lists

As we leaf through the GSIA (Global Sustainable Investment Alliance) report we are staggered by the numbers, sure demand is exceptional but the first question you have to ask yourself how can all of this money have flowed to Socially Responsible products. We don't doubt the demand, in fact only a few weeks ago, even the FT Adviser column noted that demand outstrips supply. What is in fact doubtful is that products are correctly classified.

The fact the report shows that Exclusionary Lists are still favoured, the sum of all the remaining, lighter touch screening methods, is much larger.

Reputational Risk

In a world where how you invest defines who you are Intuitions of all kinds, from Pensions to Churches to Individuals need to change their focus and really understand what their money is doing.

Long gone are the days that picking the biggest manager is a sign of good governance, on the contrary nowadays with the level of public scrutiny a perfectly proper investor might fall foul of the actions of their chosen manager, and their size is no shield for the barrage of bad publicity this will ensue. It is unheard of for a larger manager to disclose their positions to investors on a continuous basis. Transparency is improbable.

Concentration Risk

In my opinion this is, and has always been the biggest risk in any kind of investing. History books are littered with examples of very large, very well know institutions getting wiped out because they have taken too large a position in too small a market. This conviction bias is terminal, it's like selling options outright as a strategy; it's not **if** you are going to blow up, it's just **when**.

Very large managers use their size to bully the market in their favour, and here we come back to reputational risk, does your Firm, Pension, or Parish want to promote managers who purposefully try and distort the market. Who can forget the story surrounding Valeant Pharmaceuticals?

Imagine having to explain to your trustees, pensioners, or clergy that the investment which was built up over generations was significantly reduced by gargantuan fund who only had shares in 5 companies.

Duty

The responsibility that one is given when managing other people's money is supreme, it's is a terrifying endeavour full of sleepless nights, and so it should be. If your manager is not a neurotic wreck he is either unaware of his true exposures or simply blasé. There is a big difference between talking about investments and living the exposure. Gatekeepers have often strayed into Gamekeeper territory, and it usually ends in disaster.

The Duty of the Asset Owners in determining what they have invested in is absolute, Socially Responsible Investing demands it and getting caught out with lax governance can no longer be excused by the implied surety that size brings. The repercussions can take a very long time to exit the public's mind.

Faith

Whilst there is nothing inherently wrong in the proper acquisition of wealth, there is much to be said about losing the communities' or members' money. Even worse is investing that money into companies which are deemed to behave in a manner which is not acceptable to the Church in question.

Again, public scrutiny is not going to be kind to Institutions which have been found to fall foul of their own preaching. As SRI continues to develop from "badge engineering" to a highly quantified and quantifiable approach Church Investors need to be the first to make absolutely sure they are happy with what they have invested in.

Churches as well as Charities have been comparatively untouched by the recent barrage of regulations on transparency, but the tidal wave is building and soon even Churches will have to publicly demonstrate transparency and justify the whole supply chain, just as companies are doing now with the rulings on ESG.

Whilst giving money is pretty universally accepted as a good thing, donors too have more than ever to make sure they are donating responsibly. Not only does the Charity have to demonstrate effectiveness, but also that the work doesn't bring about unintended consequences of far greater magnitude than the initial cause. For example, donating clothing sound like a great idea, but what if it wipes out an indigenous clothing industry that employed 10,000 people, as has already occurred in parts of Africa.

Where is the problem?

This is best tackled with a few examples:

A world-famous magazine did a list of Top 100 most sustainable companies, yet a third of the way down we find a company which is known for using child labour. They have been approached by numerous investors about this but the practice continues.

A respected bank's socially responsible ETFs contains companies that have been flagged for human rights abuses and one that has fallen foul of a UN embargo.

Another ETF which was specifically designed to meet a Church's Worldview contained numerous companies involved in industries that we find hard to believe a church would want to be invested in such as gambling, alcohol, tobacco, armament manufacturers, human rights abusers right through to companies with poor environmental records and stranded coal assets.

A Gender Imbalance Fund which invests in companies that have good scores in terms of their workforce diversity and women in management was found to be invested in numerous cluster munition manufacturers and a company involved in human rights abuses.

Exclusionary Lists (don't) Kill Performance

In late 2016 Hermes brought out a study on the various methods to obtain ESG compliance and concluded that Exclusionary Lists are the superior path to take. In the same article, it was also demonstrated that there is no link between exclusion and performance. DB in 2015 went as far as saying that there is an increase in performance by adopting ESG factors.

Portfolios with full and complex exclusionary lists can still perform as well as any.

Over the last 4 years at Finex we have demonstrated that not only can comprehensive Exclusionary Lists give positive returns but can do so in the highly niche sector of Clean Energy and Energy Efficiency. To put this in context Finex's exclusionary lists are more comprehensive than those published by both the Dutch and Norwegian Pension Funds.

Labelling

The FT Adviser article mentions something that we have heard quite often as well, Ethical Investment need to be labelled in such a way to give the investor some certainty they are actually investing in manner that they find acceptable.

This is already happening in Australia, with a scrutiny method by their SIF which includes 6-month portfolio audit. However, despite more than $500bln invested in SRI, only a handful of those funds have subjected themselves to the SIF inspection.

The fund with the highest Ethical Rating on a UK Ethical Consumer site gives no indication on how it uses ESG factors, yet the second one goes in a reasonable amount of detail for a Retail investor. As an outsider, there is no discernible way to understand how their Ethical scoring works. The third gives a good account as well, so why is it only third? However, drilling down into their holdings, we see exposure to the same ETFs as we mentioned previously.

In Canada 97% of the trillion plus invested in SRI strategies is classified as "ESG Integration", the lightest of SRI factors. Basically, this methods screens for companies that are able to in some form report better integration.

> *The growth of ESG integration in Italy is real (+1996%), but the high growth rate is largely due to a better reporting of respondents, thanks to a refreshed questionnaire providing better clarity around integration practices.*
>
> *EuroSIF – European SRI Study 2014*

In September 2015, the EU already covered mandatory ESG Integration and Reporting into the CMU Action Plan. If all companies report, then ESG Integration as a Socially Responsible factor is totally invalid.

Publish or be Shamed

The application of these exclusionary lists is extremely simple from an operational and governance standpoint. However, the only way this is going to work industry wide is if we take a leaf from Dutch and Norwegian pension funds and publish those lists. Even a large US Church has published some very comprehensive guidelines.

We envision in the very near future that exclusionary lists will become the De Facto process by which SRI investments are labelled and those that do not publish will be untouchable.

If managers think they can get away with a gentle "Greenwash" over their portfolio, just wait and see the class actions pile up at the next market downturn.

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